

November 24, 2009

MEMORANDUM

TO: Representative Luciano “Lucky” Varela, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Economist

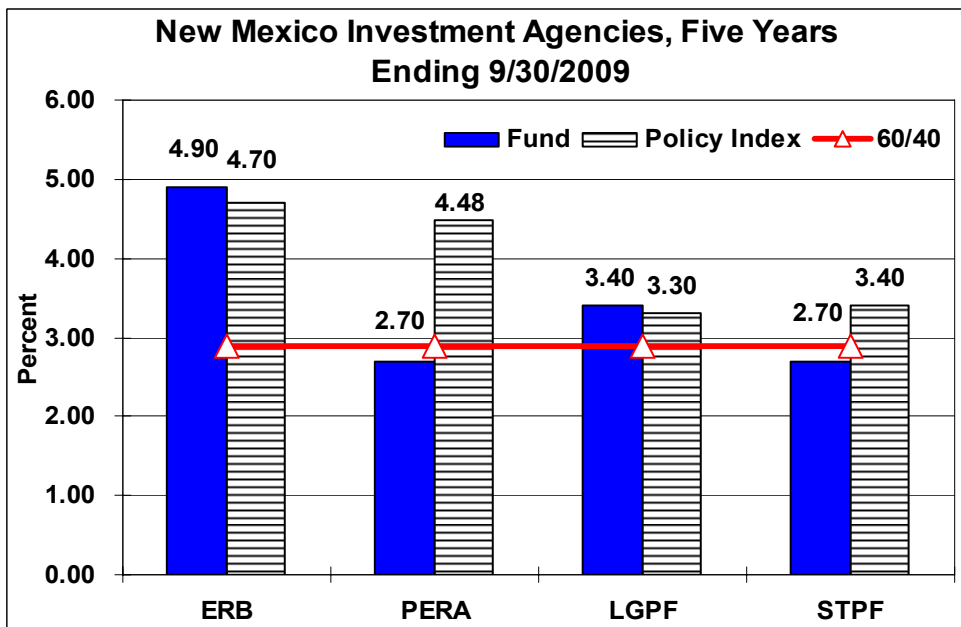
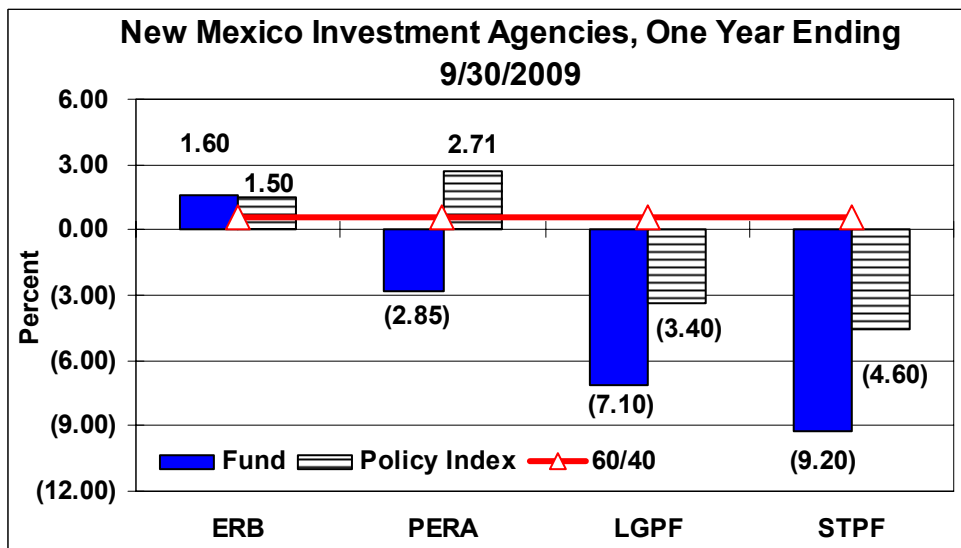
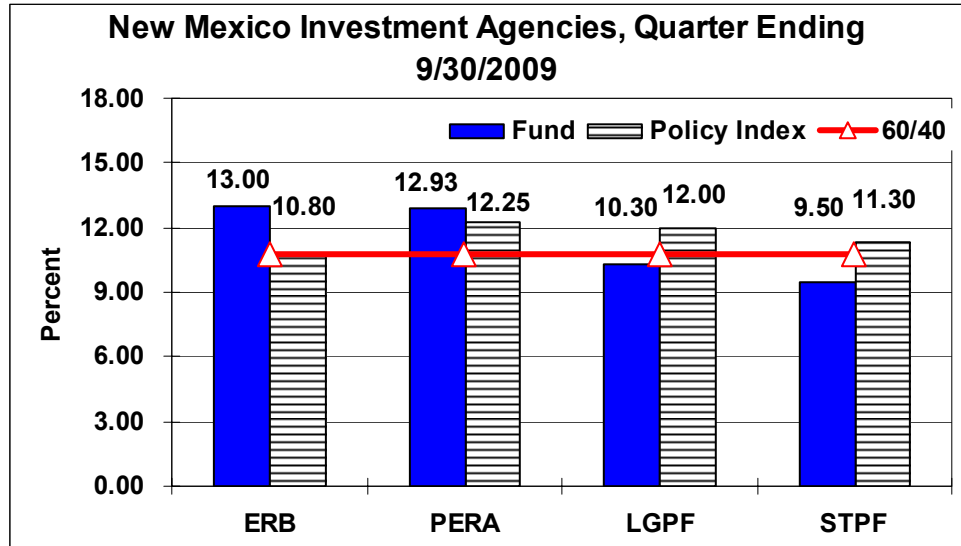
SUBJECT: LFC Report of Investment Performance – FY2010 First Quarter

Investment Performance Highlights:

- All state investment agencies were able to produce positive returns during the first quarter of FY10. However, the Educational Retirement Board (ERB) was the only fund to outperform quarterly, annual, and five-year benchmarks.
- The State Investment Council (SIC) managed Land Grant and Severance Tax Permanent Funds (LGPF and STPF) continued to underperform in the first quarter of FY10 missing quarterly benchmarks by 170 and 180 basis points (bps¹) respectively.
- The underperformance was due primarily to significantly poor performance throughout the funds’ alternative investments, which make up approximately 22 percent and 35 percent of the respective portfolios. Both funds are currently ranked in the 99th percentile for the past 12 months. The LGPF however, is still outperforming its five-year benchmark despite being ranked in the 78th percentile for the same time period.
- The Public Employees Retirement Association (PERA) beat its quarterly benchmark by 68 bps placing it in the top quartile versus other U.S. public funds for the quarter. This marks the first time the fund has outperformed its quarterly benchmark in two years. Despite the quarterly improvement, the fund is still underperforming its one-year and five-year benchmarks by 556 bps and 178 bps respectively. The fund’s one-year, five-year, and ten-year returns all currently rank in the last quartile versus other U.S. public funds.
- ERB performed the best of all state funds during the first quarter of FY10. Not only did the fund achieve the highest absolute return of all state funds, it was also the only fund able to outperform its quarterly, one-year, and five-year benchmarks. The fund has also moved into the top quartile of all U.S. public funds for a one-year time period and the 26th percentile for a five-year period.
- Peer rankings, while improved for ERB, remain extremely low for SIC and PERA particularly in the one-year and five-year time periods.

¹ Basis Points (bps) represent a hundredth of one percent. For example, if the LGPF has underperformed its quarterly benchmark by 170 bps, then it has underperformed by 1.7%.

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS



FUND ASSET VALUES

Total asset values for all funds rebounded by just under \$3 billion in the first quarter of FY10. Two-thirds of that rebound came from the pension funds which increased their values by nearly \$2 billion combined. ERB saw an increase of \$862 million, or 12.2 percent, and PERA increased its total assets by \$1.1 billion, or 12.4 percent. The permanent funds saw more modest gains of 9.4 and 7.9 percent, respectively. Total combined asset values remain down for the past twelve months by over \$2 billion. Reported asset values reflect contributions and distributions in addition to investment returns.

Current Asset Values (millions)
For Quarter and Year Ending September 30, 2009

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (9/30/09)	\$ 7,922	\$ 10,182	\$ 8,676	\$ 3,430	\$ 30,211
Value Change (Previous Quarter)	862	1,125	748	251	2,985
Percent Change	12.2%	12.4%	9.4%	7.9%	11.0%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (9/30/09)	\$ 7,922	\$ 10,182	\$ 8,676	\$ 3,430	\$ 30,211
Value Change (Year Ago)	(63.2)	(543.1)	(860.4)	(547.4)	(2,014.1)
Percent Change	-0.8%	-5.1%	-9.0%	-13.8%	-6.2%

*Excludes assets held at STO

ACTUAL VS. TARGET ASSET ALLOCATIONS

With the exception of the LGPF, all funds' alternative allocations were higher than their targets. This, similar to last quarter, may still be due to the "denominator effect" caused by a rapid decrease in overall fund values and lagged alternative valuations. This is particularly true with private equity investments. Given time these allocations should come back into line with target levels. ERB was slightly over allocated to fixed income during the quarter which proved beneficial to overall returns. The STPF on the other hand was over allocated to alternatives but significantly under allocated to fixed income during the quarter which hampered overall returns.

Fund Asset Allocation Detail, Quarter Ending September 30, 2009

	ERB*		PERA		LGPF		STPF	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	28.0%	40.0%	39.2%	38.0%	49.9%	51.0%	49.6%	48.0%
International Equity	18.8%	20.0%	22.1%	25.0%	9.0%	10.0%	11.0%	10.0%
Fixed Income	33.0%	29.0%	27.9%	29.0%	17.8%	15.0%	2.8%	11.0%
Total Alternatives	14.1%	11.0%	10.2%	8.0%	22.4%	24.0%	35.4%	31.0%
Private Equity	2.3%	1.0%	1.7%	2.0%	8.4%	6.0%	15.0%	12.0%
Real Estate/Real Assets	5.1%	5.0%	2.6%	1.0%	3.4%	3.0%	4.3%	3.0%
Absolute Return	6.7%	5.0%	5.9%	5.0%	10.6%	15.0%	10.8%	15.0%
ETI	N/A	0.0%	N/A	0.0%	0.0%	0.0%	5.3%	1.0%
Global Asset Allocation	4.9%	0.0%	N/A	0.0%	N/A	0.0%	N/A	0.0%
Cash Equivalents	1.2%	0.0%	0.7%	0.0%	1.0%	0.0%	1.2%	0.0%
Total Fund %	100%	100%	100%	100%	100%	100%	100%	100%

*ERB is adopting a new asset allocation mix that will raise its commitment to alternatives to 35% and correspondingly reduce equity and fixed income asset classes.

**Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.

LONG-TERM PERFORMANCE RELATIVE TO PEERS

Peer Percentile Rankings*

	1 Year	5 Year	10 Year
ERB	25	26	84
PERA	89	98	76
LGPF	99	78	86
STPF	99	91	91

* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds. Permanent Funds relative to U.S. Endowment Funds.

ERB dramatically improved its relative peer rankings in the first quarter of FY10 while PERA and both permanent funds' rankings remain dismal for all long-term time-periods. ERB's quarterly returns were particularly helpful to its one-year and five-year rankings which improved to inside or very near the top quartile for all U.S. public funds. Despite ranking in the 22nd percentile for the quarter PERA's long-term rankings leave room for significant improvement. The continued poor quarterly performances of both permanent funds had devastating effects on long-term rankings, dragging down the funds' one-year returns from the 89th and 93rd percentiles to the 99th percentile respectively.

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The first quarter of FY09 saw a broad market rally throughout essentially every major asset class. Equity markets in particular saw large gains as the S&P 500 increased 15.6 percent for the quarter, and most international indices gained in the neighborhood of 20 percent for the quarter. What's more, fixed income returns for the year are now in excess of 10 percent for core assets and in excess of 20 percent for high yield assets. The rally throughout fixed income markets has had the largest benefit to ERB's portfolio, playing a large part in its recent performance rebound.

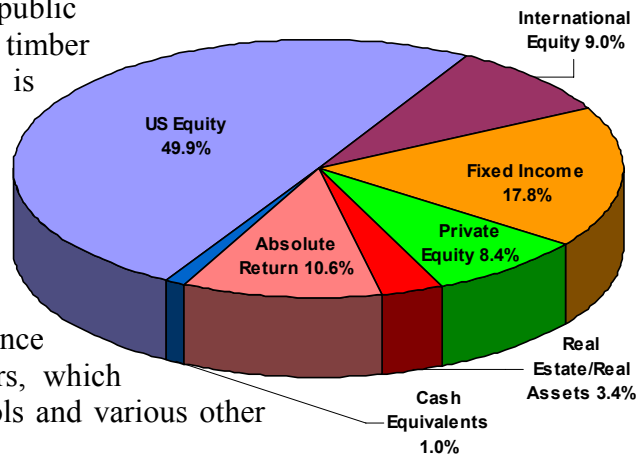
Alternative asset indices continued to perform well throughout the first quarter of FY10 with the exception of the NCREIF Property Index which is still down significantly over the past year. Most analysts believe however, that private equity valuations have yet to hit bottom as these returns generally lag public equity markets. Real Estate Investment Trusts (REITs) had the largest rally of all alternative asset classes with the Wilshire REIT index increasing more than 35 percent during the first quarter. Many analysts think that this strong rally is representative of more investors abandoning their recent flights to safety in an attempt to achieve higher yields. This will be important in the continuing recovery of the REIT and fixed income markets.

Recently a bleak unemployment picture was released as the national unemployment rate increased to 10.2 percent. This news was mitigated slightly by a 3.5 percent increase in GDP during the first quarter of FY10. Although some believe this surge in economic activity consisted primarily of one-time stimulus activities, many economists, including Fed Chairman Bernanke, have stated that they continue to see overall economic activity beginning to "level out." The Federal Open Market Committee (FOMC) has stated that they will most likely keep the target fed funds rate at unprecedented lows for "an extended period." The Fed is expected to continue its policy of low interest rates until a sustainable decline in the unemployment rate becomes evident, which most forecasting services and futures markets don't anticipate until at least August of 2010.

Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries.

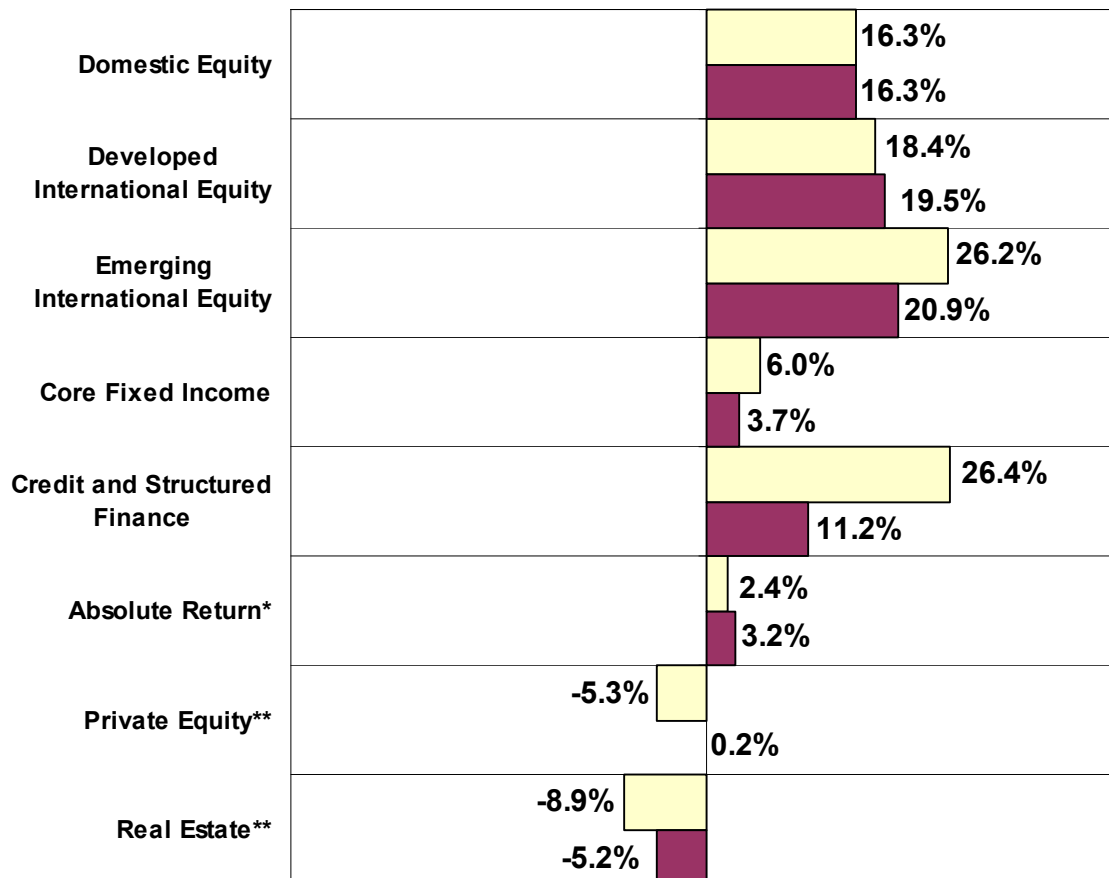
LGPF Asset Allocation as of 9/30/09



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
10.30%	12.00%	56	-7.10%	-3.40%	99	3.40%	3.30%	86

LGPF Quarterly Performance vs. Benchmarks



* Results Lagged One Month

** Results Lagged One Quarter

□ LGPF

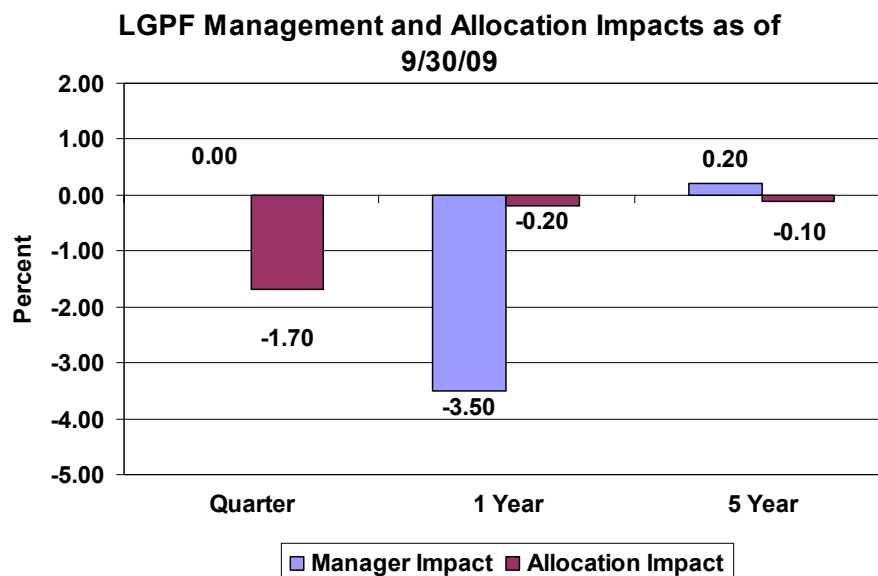
■ Benchmark

Quarterly Investment Report, 1st Quarter - Fiscal Year 2010

Overview: The LGPF underperformed its quarterly policy benchmark by 170 bps during the first quarter of FY10, marking the second consecutive quarter of underperformance by the fund. The underperformance of the past two quarters has been so large that the fund's one-year and five-year peer rankings against other U.S. endowment funds have decreased from the 35th and 34th percentiles to the 99th and 78th percentiles in just two quarters. The fund is still outperforming its five-year benchmark by approximately 10 bps.

Although the majority of the fund's underperformance and decline in percentile rankings is due to the massive underperformance during the fourth quarter of FY09, the fund markedly underperformed during the first quarter of FY10 as well. The underperformance was due primarily to poor performance across the fund's alternative investment portfolio. The combined alternative asset portfolio, which accounts for more than 22 percent of the fund's overall portfolio, underperformed benchmarks by approximately 1,000 bps combined. This underperformance was mitigated however by solid performance throughout the fund's traditional asset classes. Core fixed income and credit and structured finance assets, which make up only 17.8 percent of the overall portfolio, outperformed relative benchmarks by a combined 1,750 bps respectively. Without the solid fixed income performance coupled with a 530 bps outperformance in emerging market international equities, the fund's underperformance would have been much worse. The fund has outperformed the STPF on a pretty consistent basis over the past two years, primarily due to the fact that the LGPF carries a much lower alternatives allocation on average. The STPF is statutorily required to make a number of alternative investments, some of which are differential rate, that are not permitted within the LGPF.

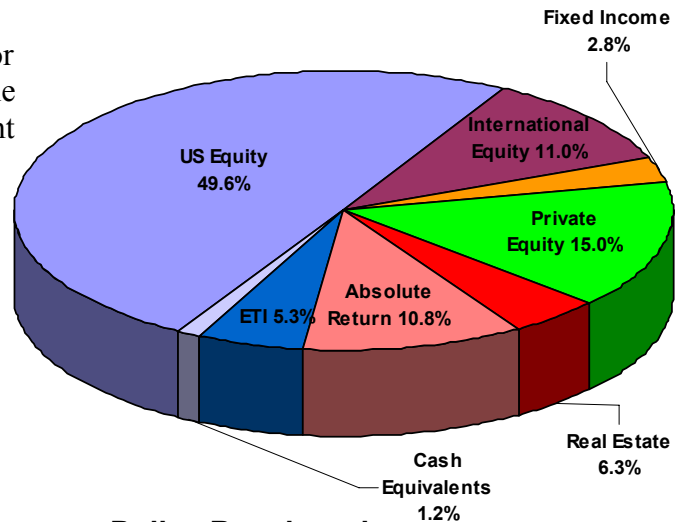
Management and Allocation Impacts: In the fourth quarter of FY09, active management had no net effect on the funds overall return while asset allocation cost the fund 170 bps. The magnitude of last quarter's negative performance caused the fund's one-year management impact to turn definitively negative despite positive manager impact throughout the majority of FY09. The large write-downs in the fund's securities lending program contributed to a large portion of these negative management impacts. Management impacts for the quarter were zero due to the positive performances within traditional asset classes being netted out by the poor performances within alternatives.



Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

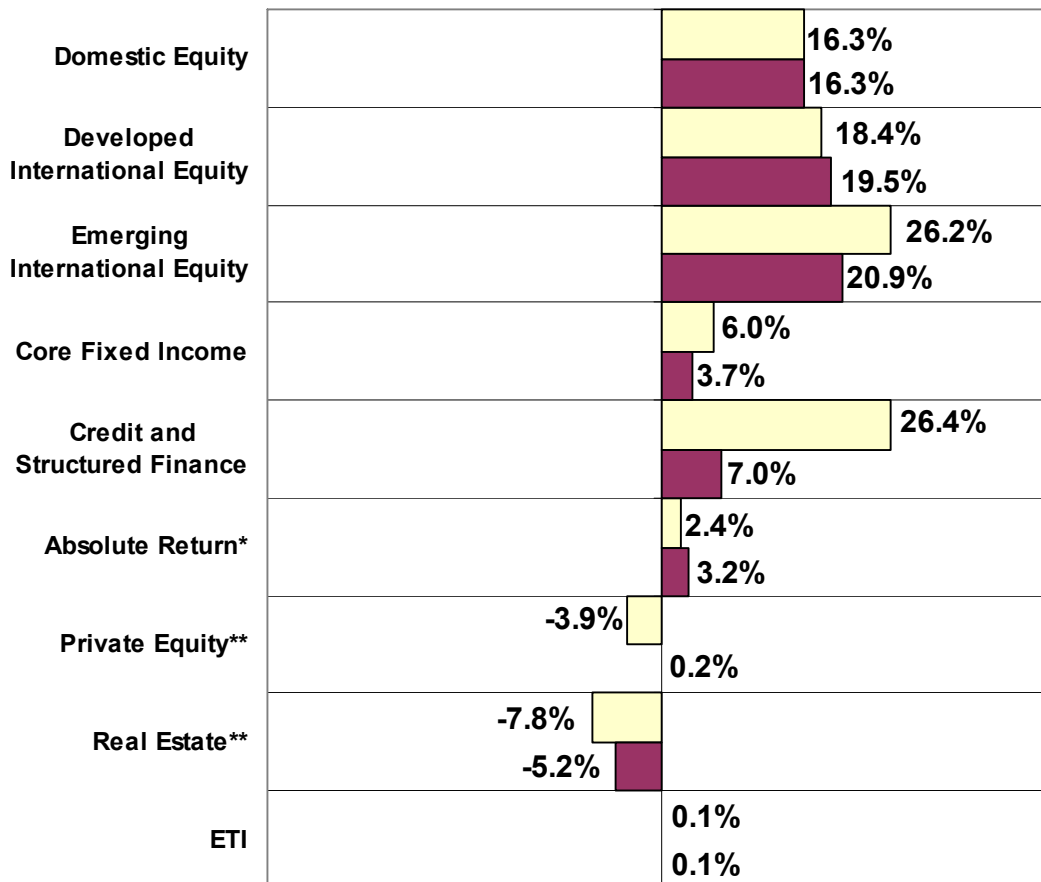
STPF Asset Allocation as of 9/30/09



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
9.50%	11.30%	65	-9.20%	-4.60%	99	2.70%	3.40%	91

STPF Quarterly Performance vs. Benchmarks



** Results Lagged Two Months

*** Results Yet to be Reported

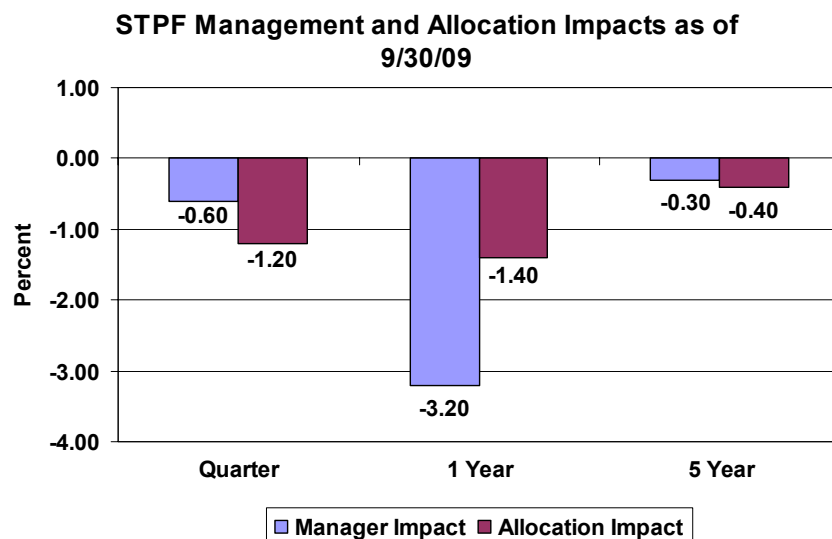
□ STPF

■ Benchmark

Overview: The STPF underperformed its quarterly policy benchmark for the second consecutive quarter, this time by 180 bps. The underperformance of the past two quarters was large enough to pull the fund's one-year and five-year peer rankings against other U.S. endowment funds from the 52nd and 46th percentile to the 99th and 91st percentiles in just two quarters.

Although the majority of the fund's underperformance and decline in percentile rankings is due to the massive underperformance during the fourth quarter of FY09, the fund markedly underperformed during the first quarter of FY10 as well. Similar to the LGPF the fund's solid performance throughout its traditional asset classes were offset by significant underperformance throughout its alternative portfolio. Although the fund's alternatives did perform noticeably better than those of the LGPF, the STPF alternative allocation is nearly 60 percent larger. This means that the underperformance experienced throughout the fund's alternative portfolio is magnified by the greater weight it receives in the overall portfolio. As discussed above, the STPF consistently holds the highest alternative allocation of all state funds. This is due to the fact that both permanent funds have been investing in alternatives for a much longer time period than the pension funds in addition to the fact that various statutory earmarks exist within the fund's asset allocation. These earmarks include the zero-interest film loan program, the New Mexico private equity investment program, a mandatory investment into the New Mexico Small Business Investment Corporation (SBIC), and a number of others. Without these statutory mandates, the fund's portfolio composition would most likely be much more in line with that of the LGPF thus bringing the fund's performance much more in line with the LGPF as well. This could have resulted in approximately 70 bps in additional returns for the STPF over the past five-years representing a possible five-year outperformance of 10 bps.

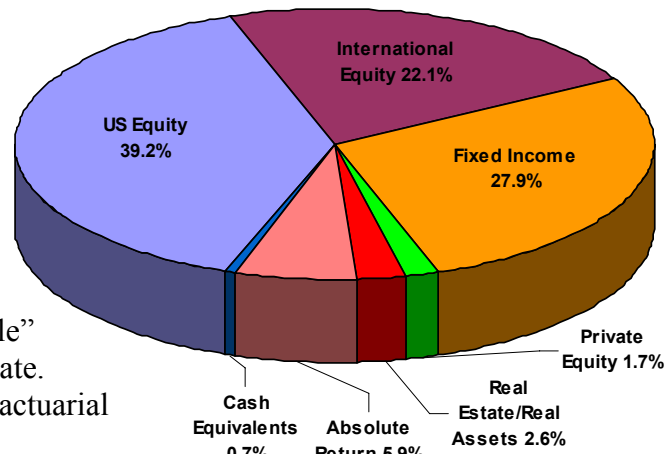
Management and Allocation Impacts: In the first quarter of FY10, active management cost the fund 60 bps while asset allocation cost the fund 120 bps. The management impact was 60 bps worse than the LGPF due primarily to the greater weight given to the large underperformance within alternative assets. Thus the fund had a much higher exposure to the asset class which suffered the greatest losses. The negative management impacts for the one-year time-period are due almost entirely to this quarter's underperformance coupled with last quarter's large write-downs.



Public Employees Retirement Association (PERA)

Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the “prudent investor rule” and results are reported in the aggregate. The fund has an 8 percent long-term actuarial benchmark for funding purposes.

PERA Asset Allocation as of 9/30/09

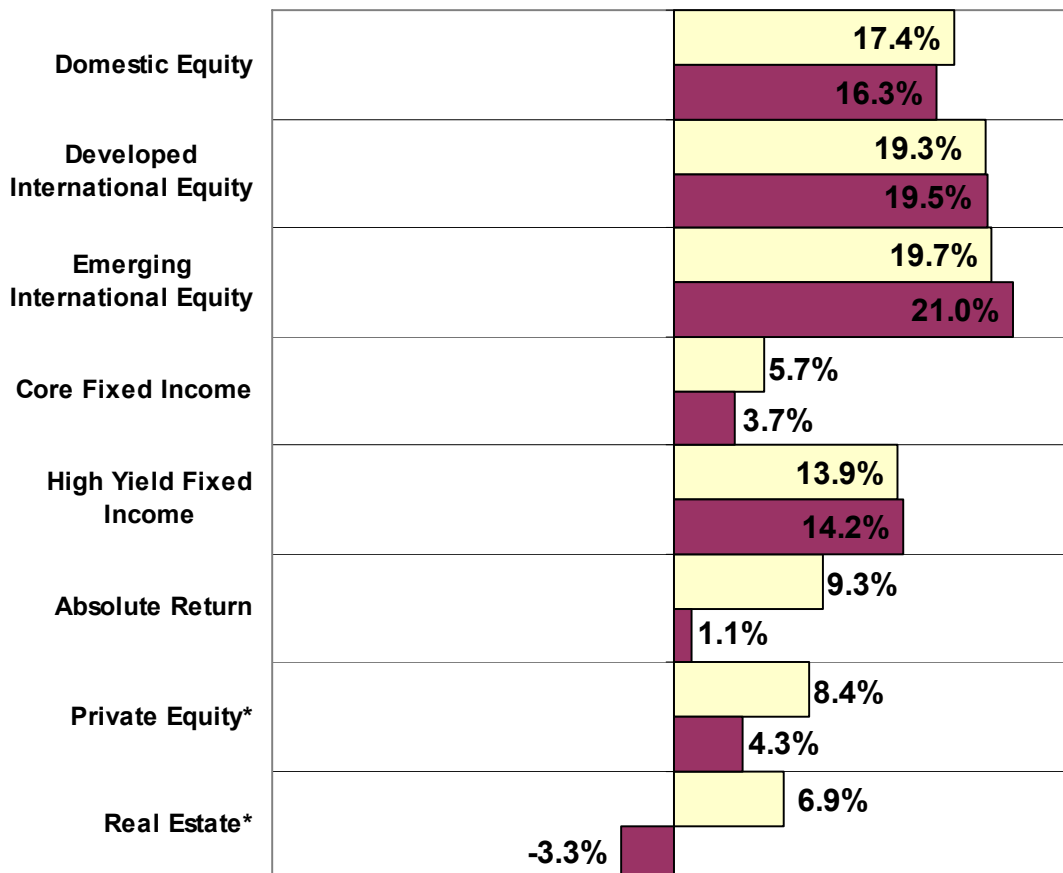


Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-2.85%	2.71%	89	2.70%	4.48%	98	4.12%	3.86%	76

*PERA also has a long-term 8% actuarial benchmark for funding purposes.

PERA Quarterly Performance vs. Benchmarks



* Lagged One Quarter

PERA

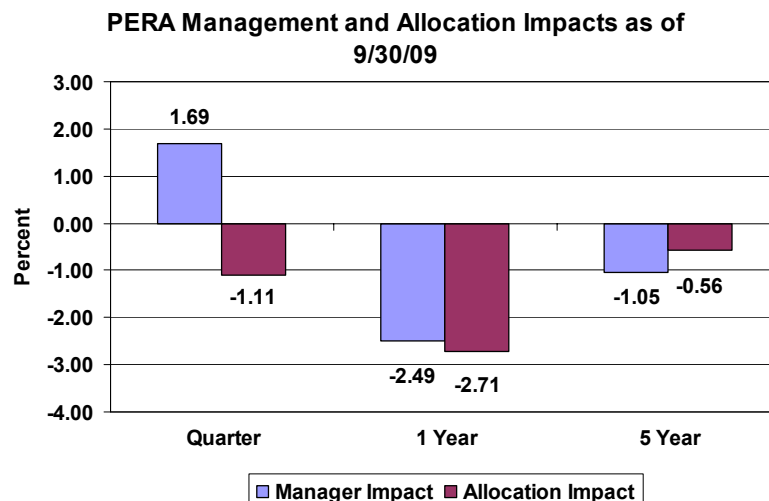
Benchmark

Traditional Assets Gross of Fees, Alternatives Net of Fees

Overview: During the first quarter of FY10 PERA outperformed its overall quarterly policy benchmark for the first time in two years. The 68 bps outperformance was good enough to rank the fund in the 22nd percentile for the quarter. However, the fund's one-year and five-year rankings remain in the bottom eleven percent of all U.S. public funds. Also improved, the fund's 10-year return of 4.12 percent is beating its relative benchmark by 26 bps. Despite the outperformance this return remains a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits. Although the recent market rebound may rule out an immediate contribution increase, the effects of the fund's consistent underperformance relative to its long-term actuarial benchmark continue to raise concerns about long-term fund solvency.

During the first quarter the fund's alternative assets performed extremely well. The returns from all three asset classes outperformed their respective benchmarks by at least 410 bps. Because these assets make up only 10.2 percent of the overall portfolio however, the bulk of the fund's quarterly outperformance can be attributed to domestic equity and core fixed income manager performance. Each asset class outperformed its benchmark by 110 bps and 200 bps respectively. International equity, which makes up more than 22 percent of the overall portfolio, continued its trend of underperformance with developed and emerging markets missing benchmarks by 20 bps and 130 bps respectively. The fund was hurt in the fourth quarter of FY09 when it underweighted international equity relative to its allocation policy missing a large rally within the asset class. The fund increased its international equity allocation closer to its policy target during the first quarter of FY10 however, manager underperformance penalized this move. The fund continues to have the largest allocation to international equity of all state funds by a significant margin, a policy which has often proven detrimental over the past twenty-four months.

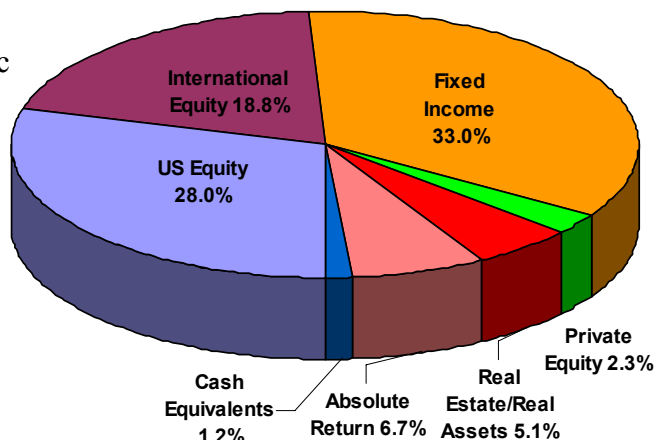
Management and Allocation Impacts: Reversing prior attribution patterns, active management added 169 bps in the fourth quarter of FY10. This number would have been much higher if not for manager underperformance within the funds international equity asset class. Active management has consistently hurt PERA returns as shown in the one-year and five-year time periods, although positive management impacts during the past two quarters are gradually improving this trend. Allocation impacts have been negative as well, a trend which is expected to reverse as the fund further develops its alternative investment portfolio.



Educational Retirement Board (ERB)

ERB Asset Allocation as of 6/30/09

Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the “prudent investor rule” to ensure retirement benefits. The fund has an 8% long-term actuarial benchmark for funding purposes.



Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
1.60%	1.50%	25	4.90%	4.70%	26	3.50%	3.80%	84

*ERB also has an 8% actuarial benchmark for funding purposes.

ERB Quarterly Performance vs. Benchmarks

Domestic Equity	14.8%	16.3%
Developed International Equity	18.8%	19.5%
Emerging International Equity	23.4%	20.9%
Core Fixed Income	8.3%	3.7%
Credit Strategies	10.9%	11.2%
Absolute Return*	6.8%	3.2%
Private Equity**	4.1%	4.3%
REIT	35.6%	35.4%
U.S. Real Estate	-0.9%	-1.6%
International Real Estate	4.0%	-3.3%

* Results Lagged One Month

** Results Lagged One Quarter

□ ERB

■ Benchmark

Overview: ERB outperformed its quarterly policy benchmark for the second consecutive quarter, this time by 220 bps. More importantly the fund is now beating its one-year and five-year benchmarks as well. The outperformance is good enough to rank the fund in the 25th and 26th percentiles for the two time periods as well. However, the fund is still underperforming its ten-year benchmark by 30 bps, ranking the fund in the 76th percentile nationally. Like PERA, the fund's 10-year return of 3.5 percent is a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits. Concerns regarding the fund's long-term solvency, though mitigated by the solid performances of the past two quarters, are still significant.

During the first quarter the fund benefited from strong manager performance particularly within the core fixed income and emerging market international equity asset classes. The fund has consistently had the highest fixed income allocation amongst state investment funds, and finished the quarter overweight by approximately 4 percent relative to the fund's target allocation policy. This relatively conservative strategy has been successful thus far, primarily due to manager outperformance. The fund's alternative assets also performed quite well during the quarter, with all asset classes outperforming benchmarks with the exception of private equity. The fund's alternative asset allocation strategy, although more mature than PERA's, is still much smaller than that of the permanent funds and similar funds throughout the country. The fund plans to increase its overall alternative allocation from its current 14.1 percent to 35 percent over the next few years. This move will assist in further diversifying the portfolio and hopefully produce increased returns at a lower level of risk to the overall portfolio.

Management and Allocation Impacts: Both the fund's asset allocation and active management added value to the fund during the first quarter, reversing a trend of poor manager performance. Despite two consecutive quarters of positive manager impact, the fund has still lost 290 bps over the course of the past twelve months due to manager underperformance. The fund's allocation impact continues to be positive due primarily to its strategy of overweighting its fixed income allocation in place of public equities. This relatively conservative strategy was a large factor in the positive allocation impact of 300 bps added to the fund's returns over the past year.

